South African Tax Considerations of hybrid financial Instruments

by

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DECLARATION

I certify that the *limited scope dissertation* submitted by me for the degree *Master of Commerce (South African and International Taxation)* at the University of Johannesburg is my independent work and has not been submitted by me for a degree at another university.

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ABSTRACT

There has been a remarkable increase in the use of Hybrid Financial Instruments in cross-border transactions. This has in turn brought about immense uncertainty as to the tax treatment thereof. Investors and tax authorities are yet to remedy the situation. Internationally there is inconsistency in the tax treatment of Hybrid Financial Instruments. Global clarity and consensus is required to answer the question; what is defined as a Hybrid Financial Instrument?

Ideally, the answer should be unanimous and unambiguous in nature. In order to achieve the latter; policies and Double Tax Agreements should be penned such that they eliminate the subjectivity and the unintended consequences resulting in double non-taxation and tax avoidance.

The present paper aims to bring to the reader's attention policy and legislation to address these identified hybrid mismatch arrangements. The researcher examined the South African tax legislation and its subsequent developments to ascertain whether South Africa was in line with certain international practices. The conclusion comprises of findings and recommendations to add to the body of knowledge in relation to the tax considerations of Hybrid Financial Instruments. The discoveries demonstrate the exigency for the persistent quest for a remedy to find conclusive and internationally acknowledged best practice. Universal synchronisation and an endorsement of further research into the identification of mismatches as a principle and not so much on the substance of the instrument itself is recommended.

KEY WORDS: Cross-border transactions, Double Tax Agreements, Double tax, Hybrid Financial Instruments, International tax, Mismatch arrangement, South Africa, Tax, Tax avoidance.

LIST OF ABBREVIATIONS

BEPS	Base Erosion and Profit Shifting
CAD	Canadian Dollar
CFC	Controlled Foreign Company
DNA	Deoxyribonucleic acid
DTA	Double Tax Agreement
DTC	Davis Tax Committee
DTT	Double Taxation Treaty
EU	European Union
EUR	Euro
FTC	Foreign Tax Credits
GAAP	Generally Accepted Accounting Practice
G20	Group of Twenty
HFI	Hybrid Financial Instrument
IAS	International Accounting Standards
IFRS	International Financial Reporting Standards
MAP	Mutual Assistance Procedure
MNE	Multi National Enterprise
MTC	Model Tax Convention
NZD	New Zealand Dollar
OECD	Organisation for Economic Co-operation and Development
SA	South African
SARS	The South African Revenue Service
UK	United Kingdom
US	United States of America
USD	United States of America Dollar
ZAR	South African Rand

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CHAPTER 1. INTRODUCTION AND PROBLEM SETTING

1.1. BACKGROUND

Andrew Jackson, the seventh President of the United States of America (US) once said,

> *'The wisdom of man never yet contrived a system of taxation that would operate with perfect equality'.*

Globally, the past two decades have borne testimony to a deluge in the sophistication involved in the structuring of cross-border transactions. As demonstrated by the Organisation for Economic Co-operation and Development's (OECD) *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (2012), policy makers and revenue authorities are in a constant battle to catch up and pre-empt these complexities (OECD, 2012).

Hybrid Financial Instruments (HFIs) have become an integral part of global business in capital raising endeavours (Parada, 2014). Given that investments will usually have tax consequences, investors find themselves considering the most suitable means of financing such investments. International investors utilise financial instruments with contractual rights and obligations in relation to pre-determined amounts, time and specific performances. Historically these have taken the form of distinctly distinguishable debt and equity financial instruments. The evolution of the financial industry has brought with it a new creature; not quite equity, yet not quite debt, in the form of HFIs possessing the 'DNA' of both debt and equity (Oguttu, 2012).

Given the subjectivity in the evaluation of the nature of financial instruments in this instance, from a Double Tax Agreement (DTA) perspective, HFIs may result in the inconsistent interpretation between sovereign state laws. One state may be more concerned about the actual form that the HFI takes, and another in its substance.

Decamp (2016) cites the example of the US and Luxembourg who both emphasise the form and substance respectively. There are therefore inherent lacunas when confronted with contradicting tax applications by the state of origin of the income and the state of residence of the recipient and beneficial owner. The determination of whether an HFI is an equity or debt instrument remains open to each country's own interpretation (Decamp, 2016).

There is therefore an appreciation of the fact that the ability to avoid tax by using HFIs stems from the diverse tax treatments of HFIs by the respective tax jurisdictions. This explains the need to review the tax treatment by other countries. Owing to the nature of this limited scope dissertation and the inherent limitations thereof, the writer of this paper has elected to examine the tax treatment in varying degrees of HFIs in a few countries covering the United Kingdom (UK), Denmark, Austria, Germany and the European Union (EU) for comparative purposes. The criterion for the selection of these particular countries was based on the availability and depth of the literature available. References are made to a particular country if that country's treatment of HFIs is relevant and beneficial in answering the research objectives of the study.

A proposed test to determine whether an HFI is a debt or equity instrument is to assess the debt and equity features within the very same financial instrument (Laguna, 2016). The uncertainty in the tax treatment of HFIs has led to the abuse of HFIs and this has led to HFIs being used as a tax avoidance mechanism (Oguttu, 2012). The extent of the problem has been so prolific it ultimately prompted the South African (SA) government to address the matter in order to protect and preserve its tax revenue base.

The continuous and evolving efforts by the SA tax authorities to stop the misuse of HFIs is illustrated as follows. The 2016/2017 budget speech in South Africa delivered on the 24th of February 2016 by the then Minister of Finance, Mr Pravin Gordhan, attempted to address transactions involving hybrid debt instruments and the resulting mismatch in the treatment thereof which could arise in two jurisdictions (Gordhan, 2016). Expressed differently, the budget speech was in relation to transactions where double non-taxation arises in the instance where the issuer of a hybrid debt instrument is a non-resident taxpayer (Van Schalkwyk, 2016).

An example of double non-taxation is demonstrated by Van Schalkwyk (2016) where he elaborates that in order to receive an interest deduction, companies issue debt instruments in the place of equity instruments because dividend payments are not deductible against taxable income. Instruments that are equity in reality, but charade as debt, are discouraged by the anti-avoidance rules contained in the South African Income Tax Act, no. 58 of 1962 (the Act). The provisions in section 8F of the Act look at the substance over the form of the financial instrument and serve to reclassify interest on 'hybrid debt instruments' and 'hybrid interest' as dividends *in specie* in the hands of the issuer and the holder of the instrument. The now reclassified dividends *in specie* are deemed to be declared and paid by the issuer, and accrued to the holder, on the last day of the issuer's year of assessment (Juta's Law Editors, 2017).

The issuer of the instrument may not qualify for an interest deduction against taxable income. The authorities have subsequently realised the anti-avoidance provisions mentioned above that apply to hybrid debt instruments do not prevent non-resident issuers from claiming an interest deduction in their resident country. This results in double non-taxation, or a mismatch between the two countries, as the holder is deemed to receive an exempt dividend *in specie* whereas the foreign issuer cannot be prevented from claiming an interest deduction (Van Schalkwyk, 2016).

The measures that arose out of the above-mentioned 2016/2017 budget speech aim to exclude the unintended consequences alluded to above where the issuer of a hybrid debt instrument is not an SA resident taxpayer (van Schalkwyk, 2016). Accordingly, section 8F has been amended by the changes as promulgated in the *Taxation Laws Amendment Act, 2017*. These changes are effective 24 February 2016 (i.e. the date that the initial announcement regarding cross-border hybrid debt was made during the 2016 Budget Speech) (Reifarth, 2017). As such, hybrid debt instruments issued by foreign companies may be excluded from the application of the reclassification rules.

Without alluding to specific references, Decamp (2016) asserts there has been a worldwide concerted effort to curtail the use of HFIs. This has, however, resulted in renewed tax consequences. The OECD recommendation that follows serves to combat the above-mentioned practice by combining anti-hybrid and anti-abuse rules. The OECD's recommendation provides that distributions by a subsidiary may be subject to an exemption in the state of the parent company. The latter proposition encompasses a rider in that the exemption is applicable only to the extent that it is not deductible by the subsidiary (Decamp, 2016).

In addition, the tax benefit of such a transaction would only materialise if the said arrangement were found to be authentic and a true reflection of the economic and commercial reality. It is incumbent upon the HFI to demonstrate a *causal nexus* between the income and the activity resulting in the income in order to benefit from the afforded tax exemption (Decamp, 2016).

1.2. RESEARCH PROBLEM

According to the Davis Tax Committee (2015), the SA fiscus has suffered financial losses amounting to at least ZAR 2.8bn. This has been because of the self-enrichment of international and domestic financial institutions utilising HFIs and foreign tax credits (FTC). The losses stem from seven transactions conducted by two major financial institutions. The amounts involved are significant and serve to further emphasise the importance of resolving the misuse of HFIs. The domestic SA financial institutions received the tax benefits whist simultaneously eroding the tax base. Had the tax benefit been taxed, the SA tax base would have been enhanced by an amount equal to the said benefit and saving (Davis Tax Committee, 2015). The question to be asked is, "what are other countries doing about the dilemma caused by the use of HFIs in hybrid mismatch arrangements for undue self-enrichment by certain taxpayers, and how does South Africa compare?" It is not clear whether SA is in line with the countries reviewed in the present study.

Hariton (1994 as quoted by Johannesen, 2014) in his article titled, '*Tax avoidance with cross-border hybrid instruments*' maintains:

'In exchange for capital, corporations can offer investors any set of rights that can be described by words, subject to any conceivable set of qualifications, and in consideration of any conceivable set of offsetting obligations'

Corporations are able to create any instrument that they may conceive or imagine (Johannesen, 2014). They are not constrained by the distinctions of the paradigms of pure equity vs. pure debt. All the holders of capital require are rights and obligations deemed worthwhile as a return on investment. Investors are therefore able to accept HFIs in return for their capital injection. Inherent in HFIs are certain rights that are counter-balanced by obligations. It is this distinction and the weighting attributed to the rights and obligations that is of concern in the present study. The interpretation of the latter qualifications and offsetting obligations determines whether an instrument is treated as debt or equity. HFIs often put together elements of debt and equity in numerous means. The various tax regimes offer their own overall classification and deem the instruments to be either debt or equity. The classification of the very same instrument may differ from one tax regime to the next. Similar to the manner in which tax regulations change from country to country so do the tax principles that delineate debt and equity (Essop, 2016).

The misuse of HFIs and tax avoidance predispositions has intensified the awareness of the hybrid instruments to such an extent that most countries have introduced specific tax rules addressing such instruments. The SA tax legislation too contains rules on hybrid instruments, and over the years, significant amendments to these rules have been promulgated (Oguttu, 2009).

Based on the context given above, the problem identified is the inconsistency in the global tax treatment of HFIs which also affects South Africa, as illustrated by the ZAR 2.8bn lost by the SA fiscus as alluded to in the introduction to the research problem (Davis Tax Committee, 2015). The current research project seeks to address the uneven nature of the worldwide tax treatment of HFIs and endeavours to lightly touch in minimal detail on the coherence in the exertion and discernment of which statute takes primacy in relation to SA tax law and DTAs.

1.3. RESEARCH OBJECTIVES AND PURPOSE

The overall objective with the present research is to provide a comprehensive overview of the inconsistent tax treatment of HFIs in the global arena with a specific focus on SA tax legislation and a comparison between SA and the chosen sample of countries. The sub-objective is to define HFIs and to explore the applicable policy and legislation in South Africa in order to afford a broad overview of the struggle when applying the tax treatment of HFIs in cross-border transactions. The second sub-objective of the research objective of this study is to provide coherence in the exertion and discernment of which statute takes primacy in relation to SA tax law and DTAs.

In order to achieve the objective above, research questions need to be answered by a detailed interrogation of the current literature with a view to addressing the following sub-objectives:

1. To define HFIs from a SA perspective and to describe the SA tax law treatment of HFIs;
2. To explore and highlight the convergence or lack thereof in the international tax treatment of HFIs;
3. To discuss the role of DTAs in relation to domestic law and to investigate which law takes precedence; and
4. To establish whether the SA tax treatment is in line with the countries reviewed.

The purpose of the research is to bring to the reader’s attention policy options and legislation to address these identified hybrid mismatch arrangements. Lastly, in addition to the latter the study seeks to contribute to the understanding of what HFIs are and how the SA tax treatment is similar or dissimilar to that of the few countries cited in the research.

The purpose will be achieved by reviewing the SA tax law and the general application of DTAs with the aim of removing the opaqueness attributable to the interpretation of HFIs and the determination of which law is to take precedence. Certain selected jurisdictions namely, the UK, Denmark, Austria, Germany and the EU are studied to gain insight into how these countries treat HFIs.

1.4. SIGNIFICANCE OF THE STUDY

The study is of significance because the current literature on the SA tax considerations of HFIs has not extensively explored the evaluation of the nature of financial instruments. This study endeavours to fill the void that currently appears in the existing body of knowledge.

HFIs may lead to double non-taxation or a mismatch between two countries. The collection of taxes and the avoidance of double non-taxation are of paramount importance in preventing the erosion of South Africa's tax base. A clear comprehension of domestic law will alleviate the lack of clarity pertaining to what the considerations and implications are when categorising a financial instrument as an HFI. The hope is that taxpayers, tax authorities, tax academics, and the like will benefit from this study.

This study will also attempt to provide as a practical example, certainty for taxpayers when utilising HFIs as part of capital raising accomplishments in South Africa for example.

1.5. RESEARCH METHODS AND DESIGN

The research design denotes the inclusive strategy chosen to integrate the various elements of the study in a coherent and logical manner, thereby making certain the research problem is addressed effectively. The research design represents the blueprint for the collection, measurement, and analysis of data (De Vaus, 2006).

According to Saunders, Lewis and Thornhill (2009) there are mainly four research paradigms through which research can be conducted in the social and management studies; these are positivism, realism, interpretivism and pragmatism. A paradigm is a worldview or framework through which knowledge is filtered. The current study is conducted in terms of the interpretive paradigm otherwise known as the constructive paradigm. According to Kawulich and Chilisa (2001) constructivism and interpretivism are linked notions that grapple with comprehending the earth as others witness it. The study falls within the interpretive paradigm because it seeks to examine HFIs, their use in mismatch financial arrangements, certain legislation in tax jurisdictions and interprets these and their various applications and finally reaches a conclusion. Simplistically the study looks at how others experience the tax considerations of HFIs and draws certain assertions.

The current paper investigates hybrid mismatch arrangements, the applicable policy, legislation, and the SA tax treatment of HFIs. HFIs are reviewed with clear research questions in mind in order to contribute the body of knowledge as well as towards finding a practical solution for the problem of hybrids and hybrid mismatch arrangements.

1.5.1 TYPOLOGY ACCORDING TO THE FUNCTION OF THE RESEARCH

An exploratory design is undertaken in relation to a research problem when there exist limited or no previous studies to mention or to depend on to forecast a result (Labaree, 2009). The design of the present study is exploratory because it is aimed at tackling a research problem that is restricted and has few prior studies. The author of the present research intends obtaining insights to address the research problems put forward by the present study. Exploratory designs are employed to assert a comprehension of how best to advance in reviewing a subject or what methodology would be successfully applicable to collating evidence about the matter (Devi, 2017).

The research design explores HFIs and resolves the problem statement by providing a proposed solution to the lucidity around the subject matter.

1.5.2 METHODOLOGY AND DATA SOURCES

The research proposal anticipates a limited scope dissertation based primarily on a literature review and is therefore qualitative in nature. The sources of information consulted include, but are not exclusively limited to tax legislation, government releases, books, journals, articles, publications, websites and any other publicly available document or piece of reliable information relevant to the research. The terms and concepts relevant to the considerations and implications, such as whether or not the outcome results in a taxing right when utilising HFIs, will be explored and explained.

Taxpayers are able to avoid tax with the use of HFIs because the transactions typically involve more than one tax jurisdiction. The existence of more than one jurisdiction leads to more than one definition of what an HFI is. It also leads to more than one interpretation and application of law. It is therefore only prudent to review other countries in comparison to South Africa. The limited nature of this paper does not allow for an extensive analysis.

A further constraint is the limited literature and information of this relatively new topic. The jurisdictions chosen, i.e. the UK, Denmark, Austria, Germany and the EU, were selected whilst bearing in mind the latter limitations. The examination of the tax treatment by these countries permits one to commence comparing SA tax law interpretation with other tax jurisdictions in order to be able to provide a comprehensive overview of the inconsistent tax treatment of HFIs in the global arena in order to assess whether SA is in line with the chosen sample of countries.

The documentary data utilised to respond to the research questions and to achieve the research objectives comprises credible sources such as:

- The Act.
- OECD MTC and Commentary.
- SA Revenue Service Interpretation Notes.
- Relevant case law.
- Articles in accredited journals.
- Text books.
- Accounting and taxation magazines and websites of professional accounting and tax bodies.

- Writings of acknowledged and well-established experts in the field of SA Tax Law and International Tax.
- Rules for the interpretation and application of statutes such as:
    - DTAs
    - The Supreme Court of Appeal,
    - The High Court, and
    - The Tax Court.

1.5.3 DATA ANALYSIS

Academic databases were searched for relevant literature using key words such as: developing countries, double tax agreements, hybrid financial instruments, South Africa, tax, and tax avoidance in relation to South Africa, the UK, Denmark, Austria, Germany and the EU.

The data collected were analysed systematically searching for relevant information pertaining to the achieving of the objectives and sub-objectives by answering the ensuing three research questions:

1. What is a HFI and what constitutes a hybrid mismatch arrangement?
2. What is the SA tax law treatment of HFIs?
3. What are the HFI tax implications from an international and DTA perspective, with a specific reference to the UK, Denmark, Austria, Germany and the EU and is SA in line with the latter sample of countries?

The validity and reliability of the research process and findings were ensured by:

- Analysing and assessing the varying views of academic authors in relation to the topic.
- Verifying literature from numerous sources where conceivable.
- Ensuring information is obtained from peer-reviewed scholarly articles where applicable.
- Making sure the sources used were credible and legitimate.

- Only using reports and articles published by revenue authorities, recognised international organisations, and credible academic journals.

The writer intends probing for information that will shed light on proposed policy in order to address the research problem. The data are analysed such that they bring to the reader's attention the legislative options available to cure the identified hybrid mismatch arrangements.

1.6. ETHICAL CONSIDERATIONS AND APPLICATION FOR ETHICAL CLEARANCE

Ethical considerations are of the utmost importance in research, given that they are the norms and standards for conduct that determines what is right and what is wrong, what is acceptable and what is unacceptable. One of the benefits of ethical standards is that they deter the fabrication or falsification of data, thus encouraging the genuine growth in knowledge and truth. The enhancement of knowledge and truth is the most basic objective of research.

The research does not include questionnaires, interviews, or the interaction with humans and/or animals. Specific ethical considerations related to this limited scope dissertation are primarily plagiarism, referencing, and the correct acknowledgment of sources. The writer has complied with all the ethical standards of the University of Johannesburg and has received ethical clearance from the University of Johannesburg's Faculty of Economic and Financial Sciences Research Ethics Committee.

1.7. LIMITATIONS AND DELIMITATIONS

Making certain the validity and reliability of the outcomes obtained are essential facets of any research. The study will attempt to sketch the numerous methods that were applied to yield a reliable and accurate data set for analysis. Notwithstanding all the quality control procedures engaged, there may still be deficiencies and limitations in the data collection technique, including missing information in the data itself.

Given the uniqueness of HFIs there is no anticipation of extremely large sample sizes of data in terms of prior research, findings, and studies. The exploratory nature of the research does not allow the writer to make conclusions that are absolute about the discoveries. The research work restricts its scope to examining the income tax consequences and does not delve into other tax consequences such as value added tax, securities transfer tax, and tax administration, for example.

One of the objectives is to review the SA and international tax implications from a DTA perspective. However, because of the nature of this limited scope dissertation and the inherent limitations thereof, the writer has elected to examine the tax treatment of HFIs in UK, Denmark, Austria, Germany and the EU for comparative purposes.

The selection criteria of the countries were based on the limited availability and depth of the data accessible on a relatively new and contentious subject matter. The selected jurisdictions appear to be most prominent and relevant in the literature review conducted for the topic. Because of the limited literature that is available, the countries were selected based on the readiness of data and information in relation to the subject matter. The researcher's aim was not to afford a detailed comprehensive exploration of the lawful circumstances in any external authority. The various foreign laws applicable to the chosen jurisdictions are not studied critically on the basis of the principle of the legal structure of the specific country. In that regard no single tax regime should be expected to be encompassed in the enquiry of all concerns addressed by the present study.

The selected countries have been included due to their level of development in the financial markets and financial innovation. Admittedly the comparison is micro in nature, but it does endeavour to fulfil the requirement that the overall subject of the study of HFIs is of current and growing interest in continued academic discussions.

The study is therefore limited to these jurisdictions and the writer of the present study acknowledges this limitation of scope.

1.8. CHAPTER LAYOUT

The report will be divided into the following chapters:

Chapter 1: Introduction and problem statement.

Introduction, background to the research topic, the problem statement, research objectives and purpose, significance of the study, explanation of the research design and research questions.

Chapter 2: Hybrid Financial Instruments and Hybrid Mismatch Arrangements.

This chapter is an examination of what in general terms constitutes an HFI. The chapter aims to articulate what an HFI is in order to define hybrid mismatch arrangements.

Chapter 3: SA Tax Law Treatment of Hybrid Financial Instruments.

This chapter comprises a study of SA legislative and South African Revenue Service (SARS) considerations and implications for the classification for tax purposes of HFIs to obtain an understanding of the SA framework in relation to HFIs. This is sought by an analysis and examination of the SA tax structure by way of a specific emphasis on companies, and the purpose will be attained by reviewing SA tax legislation, and the considered opinions of academic writers on the subject matter.

Chapter 4: International and Double Tax Agreement Tax Treatment of Hybrid Financial Instruments.

A review of the international tax treatment of HFIs with a specific reference to the UK, Denmark, Austria, Germany and the EU in order to provide a comprehensive overview of the inconsistent tax treatment of HFIs in the global arena in order to assess whether SA is in line with the chosen sample of countries.

Chapter 5: Conclusion.

A conclusion and summary of the findings from the review of international practice that may assist in answering the four research questions and thus will firstly, define HFIs and explain the SA tax treatment of HFIs. Secondly, assess the trends in the international tax practices in this regard. Thirdly, address the tax implications of HFIs from an international and DTA perspective; and finally, make a determination as to whether South Africa is in line with the countries reviewed in the present study.

Chapter 6: Recommendations.

Recommendations stemming from the subsequent findings and conclusion.

CHAPTER 2. HYBRID FINANCIAL INSTRUMENTS AND HYBRID MISMATCH ARRANGEMENTS

2.1. INTRODUCTION

The purpose of this chapter is to examine what constitutes an HFI. The chapter aims to articulate what an HFI is in order to define hybrid mismatch arrangements. HFIs, as a concept in international finance, have grown significantly and their tax treatment concerns still require further study.

HFIs by nature play a pivotal part in today's economy as recent studies demonstrate. They function as a productive way of raising capital in a cost-efficient manner, hedging risks, appraising capital flows and investment opportunities, accommodating investors' demands, and favouring investments that would not have been made otherwise. HFIs also serve as a preamble to allow for the monetisation of assets because of the fact that they are flexible in their usage and tax interpretation. HFIs and hybrid mismatch arrangements can be utilised to cater for varying regulation requirements of various countries by taking advantage of the regulation disparities (OECD, 2012).

HFIs have also been accused of being one of the causes of the financial and debt international crisis by reason of their ability to create undetectable risks (Garcia Prats, 2011). Much like HFIs, derivatives are also financial securities. The value of a financial derivative is derived from an underlying group of assets and is typically a contract or agreement between two or more parties. Like HFIs derivatives are not known for their transparency and are often criticised for their complicated nature. Warren Edward Buffet, the famous American business magnate, investor, orator and philanthropist who serves as the chairman and Chief Executive Officer of Berkshire Hathaway, cautioned in his 2002 annual report about Over The Counter (OTC) derivatives which are traded through a dealer network over the counter as the term OTC indicates not traded on a formal exchange:

> *'The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their*

toxicity clear. Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts. In my view, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.' (Buffett, 2003)

As such, many modifications that may have a particular impact in the criterion and usage of the assortment of HFIs resulting in higher complexity of the subject have been accepted, or are in the process of being embraced (Garcia Prats, 2011). Therefore, this chapter explores the definition and meaning of HFIs, including hybrid mismatch arrangements. The chapter answers the first research question: What is a HFI and what constitutes hybrid mismatch arrangements? This will be sought by an analysis and examination of the elements and characteristics of what comprises an HFI.

2.2. WHAT IS AN HFI?

Multinational corporations often look to various means to fund their offshore investments. Depending on the needs and wishes of the investor it may be desirable for an investment to take the form of debt with a fixed return and no exposure to the company's profits. Alternatively, an election may be made to opt for an instrument whose performance is not fixed but is directly related to the financial performance of the company. The former would be a debt instrument and the latter would typically be common stock or ordinary shares.

The unique elements of the chosen instruments are as follows. Debt instruments accrue interest and interest is a tax deductible expense in the hands of the issuing taxpayer (borrower). The holder of the debt instrument (lender) receives interest and the interest received is normally treated as gross income and is taxable. Equity instruments yield a dividend and the dividend is not taxable in the hands of the shareholder. The dividend is a return on profits that have already been taxed (Davis Tax Committee, 2015). The examples cited above are distinct. The difficulties arise when a financial instrument is hybrid in nature and has elements and features that are debt and equity in nature. The two examples that follow illustrate the complexity of the subject matter.

The first example is a convertible bond which is the most frequently found type of security. It is a bond or debt instrument, which accrues interest, but may later on redemption, at the option of the issuer be converted into an equity instrument that would participate in the profits of the enterprise. It is a debt instrument with equity like features (Essop, 2016).

The second example is the equally favoured financial instrument; the convertible preference shares. Convertible preference shares provide a return in the form of a dividend which may be fixed or floating. They are referred to as preference shares because they are paid and receive preferred treatment in that their dividend is paid before the dividend attributed to ordinary shares. Like convertible bonds, convertible preference shares can be converted into equity, hence their hybrid nature (Essop, 2016).

Taking the liberty of assuming there is consensus on the English and investor meaning of the word *'financial instrument'*, the most contentious part of the words *'hybrid financial instrument',* being the word *'hybrid',* remains to be assessed. According to the Oxford English Dictionary (Oxford University Press, 2017), the noun 'hybrid' means:

> *'The offspring of two plants or animals of different species or varieties, such as a mule, a thing made by combining two different elements.'*

The adjective 'hybrid' means:

> *'Of mixed character; composed of different elements, and bred as a hybrid from different species or varieties.'*

Essop (2016) postulates that it is clear from an examination of various studies that the definition and classification of HFIs differs. However, although there is no universally accepted definition of what constitutes an HFI there exists consensus on the fact that HFIs exhibit debt and equity features. An extension of this definition to corporate funding, or more specifically to financial instruments, refers to a financial instrument *'of mixed character, composed of different elements'* (Essop, 2016).

Niels and Van Gelder (2013) define an HFI as a financial instrument which is deemed debt in country A where an expense on the instrument is tax deductible, though in country B the same financial instrument is perceived as equity and the income is considered a tax-exempt dividend. Consequently, among many concepts that have been operationalised, it can be considered that HFIs are instruments that combine both components of equity and debt, and are from time to time also referred to as 'mezzanine finance' (Garcia Prats, 2011).

2.3. WHAT CONSTITUTES AN HFI?

HFIs have both debt and equity characteristics. Customarily, equity and debt have been regarded as having separate and well-defined trends, although their features, elements, and definitions differ from one jurisdiction to the other subject to the advancement in case law and legislation in a particular country. García Prats (2011) compiled the following comparative table as a framework to differentiate debt and equity.

Table 2-1: Equity Trends vs. Debt Trends

EQUITY TRENDS	DEBT TRENDS
No assured investment return	Right to claim return
Full business risk	Credit risk
Voting right	Lack of voting right
Liquidation right	Fixed/predetermined return
Subordinated payment	Repayment preference if default

Source: (Garcia Prats, 2011).

For decades, authoritative and statutory institutions in financial accounting and income taxation have grappled with the appropriate categorisation of HFIs. The topical proliferation of novel and innovative financial instruments has deepened the debate (Thomas & Sellers, 1992). The correct classification as debt or equity is of particular significance and relevance for investors and other users of financial material (Fargher, Sidhu, Tarca & Van Zyl, 2016).

The determination and categorisation of hybrid instruments differs from country to country. There is, however, current concurrence that such instruments have composite elements of equity and debt (Clor-Proell, Koonce & White, 2016). The combination element, as well as its subsequent implications and treatment that is of critical importance in this paper.

It is widely accepted that the sources of funding a business are either in the form of equity or in the form of debt. Hence, the division of a conventional balance sheet into a debt component and an equity component. The distinguishing feature between equity and debt is the fact that equity connects to ownership and debt is not connected to ownership. In addition, equity is exposed to all of the risks and rewards of owning the business. Depending on the perception and interpretation related to the flow of funds, the funds may, for income tax purposes, be treated very differently. Issues of uncertainty in taxation ascend as the classification of the instrument could result in differences depending on the tax regimes in question (Seminogovas, 2015).

According to Johannesen (2014), global and cross-border variances in guidelines introduce and make quite possible instances where a financial instrument is classified as debt in a particular tax jurisdiction and equity in a different tax jurisdiction. A momentary look at financial instruments, such as a perpetual loan or non-redeemable bond, finds in one instance that they are categorised as equity in some jurisdictions. This is in relation to the equity-like features given that the lender is not paid back the loan. They are debt in other instances in relation to the debt-like features where the lender has no right to vote and is not fully exposed to the risk of the enterprise (Johannesen, 2014).

The importance and ability to define and identify an HFI is demonstrated in the example that follows. A local corporation invests in a foreign subsidiary using an HFI. The HFI is characterised as a debt instrument in the foreign jurisdiction and equity locally. The tax implications are such that payments in respect of the HFI are handled as tax-deductible interest expenditure in the foreign jurisdiction and as tax-exempt dividends locally (Johannesen, 2014). The Davis Tax Committee, (2015, p. 20) captures the above example crisply by making reference to the 2014 *OECD Report on Hybrid Mismatches* wherein a HFI is described as:

> *'…any financing arrangement that is subject to a different tax characterisation under the law of two or more jurisdictions such that a payment under that instrument gives rise to a mismatch in tax outcome.'*

Given that the dividend is exempt and is not treated as gross income, or in the alternative the equity payment by the foreign country is deemed non-deductible, the situation garners tax savings worth considering by many corporates (Johannesen, 2014).

Even though this paper does not focus on the accounting treatment of HFIs, it is worth mentioning the far-reaching impact that HFIs have in the financial world. Accounting for compound financial instruments such as HFIs with both debt and equity individualities presents difficulties for the writers of accounting standards and accounting practitioners (Fargher *et al.*, 2016)

Seminogovas (2015), in his paper on *Taxation of Hybrid Instruments,* contends that numerous states possess their specific, self-styled local Generally Accepted Accounting Practice (GAAP), which are in the main in accordance with International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) for the most mundane of transactions. The disparities become apparent and more complex in the instance of more intricate matters, including in the accounting for hybrid instruments. The accounting principles are paramount for the taxation of hybrid instruments. The chosen accounting treatment will have a bearing on income recognition and subsequently on the outcome of the financial results ultimately reported to the stakeholders. Seminogovas (2015) then argues that the problematic form of hybrid instruments, variances in financial reporting, and taxation amid tax jurisdictions at present are the foremost reasons for tax avoidance and tax evasion.

The dilemma brought to bear by HFIs is not limited to European or western financial reporting. Sukuk, according to Hossain, Uddin and Kabir (2018), is an Islamic duplication of a bond. It is a structured financial instrument invented about 20 years ago in accordance with the historic progression of Islamic finance. Notwithstanding the prodigious evolution of the international sukuk market, the academic studies on sukuk is at its embryonic stage, principally because researchers are yet to study sukuk in detail.

Currently, there is a bourgeoning volume of sukuk literature established on qualitative analysis speaking to shari'ah guidelines, ethical considerations, characterising distinctive features, contractual tools, and the frameworks of sukuk.

Utilising the scholarly review as a basis on sukuk features, Hossain *et al.* (2018) reason that sukuk is an HFI with traits of both bond and equity, even though sukuk is professed an Islamic equivalent to the straightforward normal bond. Accordingly, being a hybrid financial asset with to a certain degree the countenances of bond and equity, how a sukuk will most probably be priced in the money markets remains an theoretical predicament (Hossain *et al*., 2018).

2.4. HYBRID MISMATCH ARRANGEMENTS

Harris (2014), in Chapter V of *Neutralizing Effects of Hybrid Mismatch Arrangements* of the United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries, states that even though the OECD Draft does not expansively define a ‘hybrid mismatch arrangement’, it does, however, summarise the critical rudiments of such an arrangement as:

- The arrangement’s outcome is a mismatch in the tax treatment of a payment.
- The arrangement has a hybrid element.
- The hybrid element results in a mismatch in tax consequences.
- The mismatch in tax consequences decreases the aggregate tax payable by the participants in the arrangement.

Harris (2014) further argues that there is no effort to individually define ‘hybrid’, ‘mismatch’ and ‘arrangement’, nevertheless it appears the OECD regards at a minimum the first two in a comparable custom. The term ‘hybrid’ in this context concentrates on two tax jurisdictions applying identical income tax fundamentals in different ways, whilst ‘mismatch’ only looks at results that are advantageous to the taxpayer (and not those that may possibly cause double taxation). Thus it is essential to highlight there can exist numerous stratums of intricacy. Arrangements taking advantage of differences in the tax management of instruments, entities or transfers amid two or more jurisdictions are regularly premised upon analogous fundamental aspects and target attaining results that are alike.

HFIs are underpinned by hybrid arrangements utilising what are referred to as conduit structures to facilitate the desired tax outcome. Hardeck and Wittenstein (2016) cast light on these three kinds of hybrid arrangements. The hybrid arrangement comprises of three elements. The hybrid element may take the form of organisation or an HFI. The resulting type of arrangement can be further split into hybrid entities, hybrid securities and hybrid conversions. All three resulting types of hybrid arrangements have their own separate predominant tax outcome.

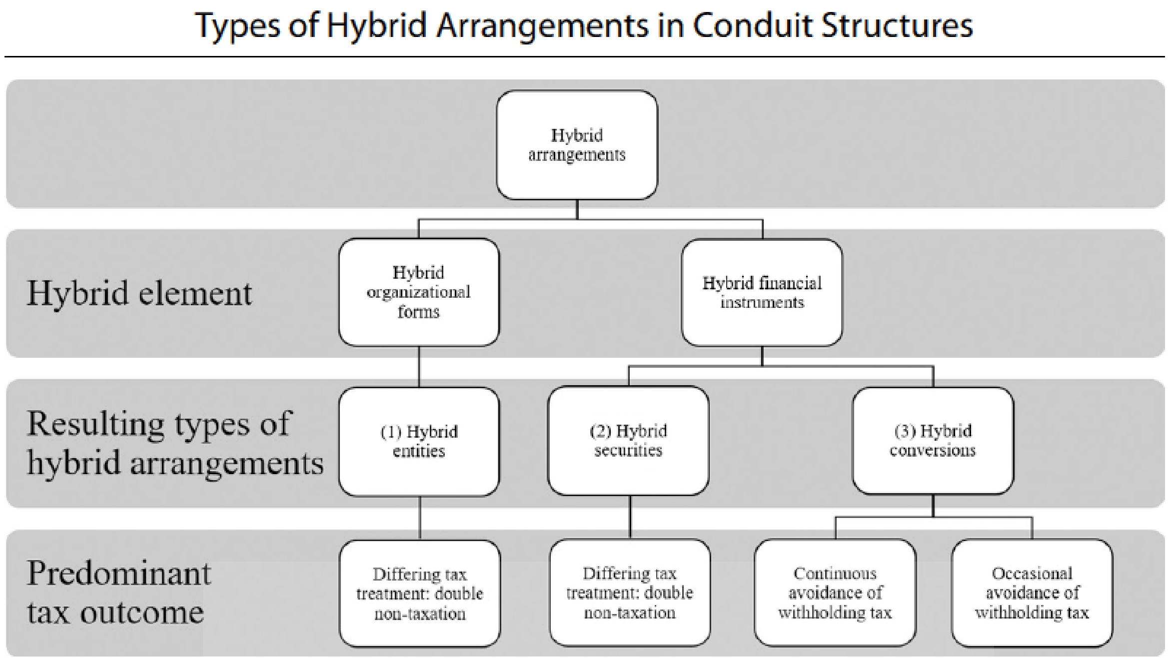

Figure 2-1: Types of Hybrid Arrangements in Conduit Structures Illustrating Targeted Schemes (Hardeck & Wittenstein, 2016)

The targeted schemes are commonly used and serve to erode the tax base of the participating countries. It is contended that the 'unfair' advantage negatively impacts competition, efficiency, transparency and fairness. To this end the OECD/(Group of Twenty) G20 BEPS Project requested recommendations in relation to the structure and construction of local regulations and statute as well as the propagation of model treaty provisions that aim to nullify the tax consequences of hybrid mismatch arrangements and bring harmony (OECD, 2015).

2.4.1 ELEMENTS OF HYBRID MISMATCH ARRANGEMENTS

There are basically four elements that may be used in hybrid mismatch arrangements, as stipulated in the OECD's Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues (2012). The elements referred to above are broken down in the table that follows.

Table 2-2: Elements of Hybrid Mismatch Arrangements (OECD, 2012)

Element	Description
Hybrid entities	Entities that are treated as transparent for tax purposes in one country and as non-transparent in another country.
Dual residence entities	Entities that are resident in two different countries for tax purposes.
Hybrid instruments	Instruments which are treated differently for tax purposes in the countries involved, most prominently as debt in one country and as equity in another country.
Hybrid transfers	Arrangements that are treated as transfer of ownership of an asset for one country's tax purposes but not for tax purposes of another country, which generally sees a collateralised loan.

Of the four elements, the most common and connected to this research is the hybrid instruments which encompasses both hybrid debt and hybrid equity financial instruments. HFIs are instruments that are treated differently in the countries involved and because of that offer a tax benefit because of the mismatch in the tax treatment. One country may treat the instrument as debt and another may treat the instrument as equity.

2.4.2 *EFFECTS OF HYBRID MISMATCH ARRANGEMENTS*

Hybrid mismatch arrangements' intentions result in one of the ensuing outcomes:

- Double deduction schemes: Arrangements where a deduction regarding the equivalent contractual obligation is claimed for income tax purposes in two distinct countries.
- Deduction / no inclusion schemes: Arrangements that generate a deduction in one country, usually a deduction for interest expenses, but circumvent a matching inclusion in the taxable income in another country.
- FTC generators: Arrangements that generate foreign tax credits that debatably would otherwise not be accessible, at least not to the equivalent degree, or not without more corresponding taxable foreign income.

Source: (OECD, 2012).

For the purposes of a graphic illustration, below is an example of a 'double deduction scheme' as explained above (OECD, 2012).

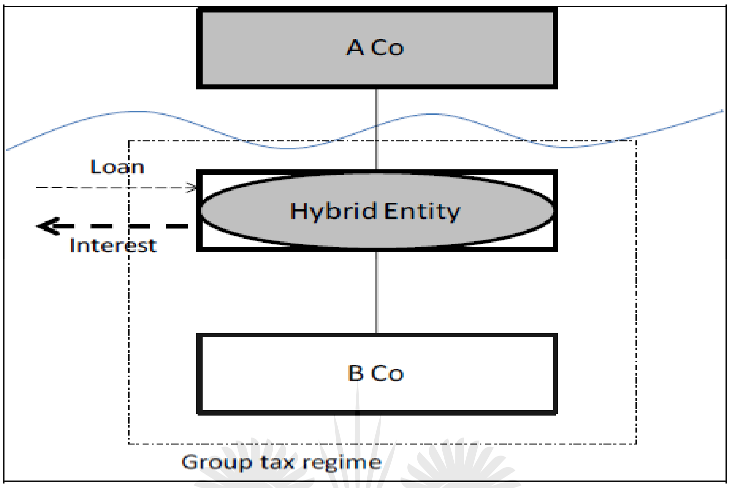

Figure 2-2: Double Deduction with Hybrid Entity (OECD, 2012)

The above figure explains a scenario where a parent company in country A (A Co) indirectly owns an operating company in country B (B Co). Incorporated between A Co and B Co is an entity (Hybrid Entity) that is regarded as see-through or excluded for country A's tax intentions, and as opaque for country B's tax ends.

A Co holds 100% or nearly all of the equity participation in the Hybrid Entity which in turn has the entire or almost all of the equity stock in B Co. Hybrid Entity is lent money by a third party and utilises the loan amount to insert it as equity into B Co. Hybrid Entity makes interest payments on the loan. Notwithstanding the interest payments, Hybrid Entity does not request any other material deductions and does not have any meaningful income (OECD, 2012).

The double tax deduction occurs as follows. Hybrid Entity and B Co, operate in Country B under a group tax regime. This means their (B Co and Hybrid Entity) tax liability is computed on a group basis i.e. collectively and not on an individual basis.

The interest on Hybrid Entity is tax deductible and therefore the group as a collective benefits. The tax deduction is not ring-fenced. In Country A the keynote is the fact that Hybrid Entity is disregarded and the interest on the loan is attributed to holding company namely, A Co; hence the double deduction. A deduction in A Co and a deduction for the group, Hybrid Entity and B Co.

2.5. CONCLUSION

The purpose of this chapter was to examine what constitutes an HFI and to articulate the essence of what an HFI is in order to define hybrid mismatch arrangements. There are a myriad of HFIs and they will continue to develop as the global economy changes in the face of continuous financial evolution. The constitution of several HFIs, such as convertible bonds in convertible preference shares in 2.2 and sukuks in 2.3, for example has also been examined.

The purpose has been to adequately describe the elements contained in an HFI. An understanding of the parts of an HFI makes it possible to distinguish which SA tax concerns are applicable. The thorough appreciation of the characteristics of an HFI has set the scene to hone in specifically on the domestic environment in South Africa and how South Africa treats HFIs in the chapter that follows.

Although there is no universally accepted definition of an HFI, there is consensus amongst scholars that HFIs comprise a combination of debt and equity features. In corporate funding, the concept refers to a financial instrument of a mixed character, encompassing the different elements. The chapter has also clarified what constitutes an HFI and the categorisation of how various jurisdictions perceive and apply debt and equity.

Having introduced the topic, the problem setting as well as a discussion on what makes up an HFI to understand what defines a hybrid mismatch arrangement we now turn to examine the SA tax law treatment of HFIs. The importance and an appreciation of HFIs and hybrid mismatch arrangements is crucial in applying tax law.

CHAPTER 3. SOUTH AFRICAN TAX LAW TREATMENT OF HYBRID FINANCIAL INSTRUMENTS

3.1. INTRODUCTION

The purpose of this chapter is to study SA legislative, SARS considerations, and implications for the classification for tax purposes of HFIs to obtain an understanding of the SA framework in relation to HFIs. The purpose will be attained by reviewing SA tax legislation.

Considerations and implications in respect of HFIs vary from country to country. It is the very differences between countries that allow for the use and abuse of HFIs. In an effort to bridge this abyss caused by the different tax treatment between countries section 8F sought to distinguish further the differences between debt and equity instruments. The *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004* (Explanatory Memorandum) on section 8F of the Act was brought to bear to separate debt and equity for tax purposes and to counteract tax avoidance stemming from the lacuna caused by the country to country differences in the tax treatment of HFIs (National Treasury, 2004).

The previous chapter defined HFIs from a SA perspective as part of the first stated sub-objective. Having obtained a clearer comprehension of what constitutes an HFI, Chapter 3 examines HFIs with a particular reference to South Africa by answering the research question; 'what are the SA tax considerations in relation to hybrid mismatches?' The objective is to describe the SA tax law treatment of HFIs to answer the research question above.

3.2. AN ANALYSIS AND EXAMINATION OF THE SOUTH AFRICAN TAX SYSTEM

Section 1 of the Act contains the very broad 'gross income' definition that determines which amounts should positively be included in the gross income of the taxpayer. The income tax system of South Africa follows the international convention and accordingly has dual sets of regulations when applying its tax regime to debt and shares (equity). Section 11(a) of the Act read with section 23(g) form the basis of the general deduction formula in that they determine what may and may not be deducted from a taxpayer's gross income. Section 11(a) of the Act provides for what may be deducted and section 23(g) of the Act provides for what may not be deducted (Ostler, 2013). In as far as it relates to the payment and receipt of interest, the debtor is permitted a tax-deduction for the interest remitted and the recipient of the interest must in turn include the interest received in his/her gross income. The legal form of a financial instrument determines its subsequent tax treatment. A debt instrument is subject to the above-mentioned treatment, and payments in relation to an equity instrument are treated as a return of capital or as a dividend (National Treasury, 2004).

South Africa has attempted to deal with the advent of HFIs by introducing sections 8E and 8F of the Act as the hybrid instrument deeming provisions. Section 8E was first introduced in 1989 and subsequent amendments were made to the legislation. The amendment to section 8F is so vast that it no longer resembles its latter form. Further additions were introduced to the Act and these were encapsulated in section 8FA. South Africa has for tax purposes included particular definitions in section 8E for 'financial instrument' and 'hybrid equity instrument' and in section 8F of the Act the definition of a 'hybrid debt instrument'. The stark emphasis is made clearer in the inclusions of a further definition in section 8FA of the Act determining what 'hybrid interest' is (Essop, 2016).

The purpose of Sections 8E, 8EA, 8F and 8FA of the Act is to re-characterise the yields on debt and equity financial instruments. The aforementioned sections are all relevant as an upshot of the disparate tax treatment of the yields on debt and equity. These sections include:

1. Crucial elements of when the return on debt and equity financial instruments should be administered as debt or equity;
2. When the utilisation of debt or equity is rendered suitable, and
3. When the deduction of interest from income should be permissible (Income Tax Act, no. 58 of 1962).

The varying tax treatments of the yields on debt and equity, and the prerequisite to introduce the sections stated in this paragraph to confront these apprehensions continue to generate difficulties in the tax system (Wortmann, 2015). From a SA and domestic tax perspective, the efforts have to some degree contributed to providing clarity on the tax treatment of HFIs. In a perfect world one would ideally as a first prize seek a globally uniform approach. The global variation in tax treatments however continues to require countries to amend their domestic tax laws in an effort to minimise the erosion of their tax bases.

Sections 8E, 8EA, 8F and 8FA are presented in a similar framework in the Act comprising the appropriate definitions and the subsequent inclusions and exclusions to the respective section. Prior to delving into the detail of each of the sections, a brief introduction of the purpose of each section is provided. The four sections are anti-avoidance rules and are termed as such and in accordance with their name serve to combat tax avoidance (EY Global Tax Alert, 2016).

The rules in sections 8E and 8EA of the Act's purpose is to discourage and penalise the use of debt instruments charading as equity with the objective of avoiding taxation. When applied, the received dividend is deemed income, which is then taxable in the hands of the recipient but retains its dividend and non-deductible status in the hands of the dividend payer (EY Global Tax Alert, 2016).

Sections 8F and 8FA of the Act target cross-border hybrid debt instruments and hybrid debt instruments subject to subordination agreements.

The effect of applying the rules in 8F and 8FA of the Act is to re-categorise the presented debt instrument as equity if the terms and conditions of the yield calculation display equity like behaviour (EY Global Tax Alert, 2016). A simple example would be an interest payment that is somehow linked to the profitability of the company. The interest payment is unwound and re-determined as a dividend *in specie*. Furthermore the issuer is denied the anticipated interest deduction and in addition is liable for the withholding tax at 20% in relation to the dividend *in specie* (EY Global Tax Alert, 2016).

The tax avoidance that is being counteracted by section 8F of the Act may be found in an interest-bearing debenture permitting the holder to alter the interest-bearing debenture into an ordinary equity share (Louw, 2016). The prevention of this specific practice is further entrenched in section 8F(2) of the Act, which considers any interest sustained by a company in relation to a hybrid debt instrument *post facto* to be a dividend *in specie* and thus equity in characterisation.

Referring to the article by Callaway (2014) titled *Hybrid Debt Instrument Taxed as Dividends* the appropriate caption which the researcher of the present finds most reflective of the revenue authorities position reads, *'A horse that looks like a cow is still a horse'* (Callaway, 2014). A deeper examination of each individual section follows.

3.3. SECTION 8E DIVIDENDS DERIVED FROM CERTAIN SHARES AND EQUITY INSTRUMENTS DEEMED TO BE INCOME IN RELATION TO RECIPIENTS THEREOF

Section 8E of the Act deals with dividends derived from certain shares and equity instruments effectively being changed and deemed income. The dividend is from a SA perspective, no longer treated as exempt income in the hands of the recipient; it is taxable and forms part of his/her gross income.

The purpose of this discussion is to review and understand the current SA legislation and to gather an appreciation of the complexities and intricacies the revenue authorities have dealt with through the various amendments. An appreciation of the difficulty and complicated nature of the subject matter is self-evident. In the absence of Dividend Withholding Tax (DWT), which may or may not be applicable a dividend from an equity instrument is normally treated as exempt income in accordance with section 10(1)(k) of the Act. It is important to note that DWT may or may not be applicable to both resident and non-resident taxpayers. It is dependent on the prevailing circumstances. Section 8E of the Act, subject to certain conditions and requirements deems and makes its own determination and re-characterises a dividend that would ordinarily be exempt in the recipient's hands and deems it income.

Being an anti-avoidance provision that overrides the normal provisions of the Act, section 8E of the Act looks at the substance over form of the dividend derived and deems that although in form the payment is a dividend in actual substance it is the receipt of interest and is thus income. A taxpayer's efforts to structure the HFI with the intention of receiving an exempt dividend are thus nixed. In fact, the payment is taxed in South Africa without a corresponding deduction in the hands of the HFI issuer.

Section 8E of the Act was introduced in 1989 to bring an end to the tax losses the fiscus was enduring from the use and abuse of cumulative redeemable preference shares (Tettey, 2016). The latter cumulative redeemable preference shares' borrowing cost was disguised as a non-deductible dividend. The receiver of the borrowing cost was not receiving interest but rather a tax-exempt dividend. Significant amendments were crafted to section 8E of the Act in 2007 and these subsequently resulted in substantial revisions and amendments to section 8E of the Act in 2011 and again in 2012. The purpose was to bring into line and make the taxation implications congruent with the actual economic substance (Tettey, 2016). National Treasury found the meaning and scope of section 8E of the Act to be too narrow and sought to amend the legislation to widen the reach of the definition of a 'hybrid equity instrument'.

This enabled the legislation to include, over and above the two categories of financial instruments classified as hybrid equity instruments, additional shares that were in the past disguisable as debt. The additional shares to be regarded as hybrid equity instruments comprised shares of a company where the life of the company is restricted, or is expected, to be ceased within three years from the issuance of shares which encompass preferences. The cessation element in this case principally functions as an entitlement to redemption or disposal (National Treasury, 2004).

Practitioners are able to make certain a share does not qualify as a 'hybrid equity share'. This is done by ensuring the redemption date is more than three years from the date of issue of the share by the entity (ENSafrica, 2018).

According to ENSafrica (2018), the SA Revenue Service had earlier specified that the 'date of issue' is not regarded with reference to a set date, but refers to the date on which a compulsion or right to redeem manifests itself. Furthermore, the Explanatory Memorandum provides that:

> *'Importance is placed on the redemption features added after the initial date of issue of the share. For instance, a company originally issued a non-redeemable preference share and subsequent to the original date of issue the terms of the share are altered to make the share redeemable within three years' (National Treasury, 2004).*

Despite the fact that an Explanatory Memorandum does not have the potency of law, it does however provide a suggestion of the legislature's intent. Therefore, in ENSafrica's (2018) view,

> *'… where a share has been issued and the issuer has an obligation or the holder a right to redeem after more than three years, and the parties subsequently agree to extend such redemption date (and such extended redemption date is within three years from the date of the variation), the obligation or right to redeem arises on the date that the shares were originally issued and no new 'date of issue' should arise upon this variation of the terms'.*

The meaning and scope of section 8E of the Act was widened to include additional equity instruments that would otherwise have escaped the previously narrow definition. The legislative change has added certainty but it deserves mention that the constant evolution of the HFI sections demonstrates that the plight of seeking finality regarding HFIs is some time away and this paper aims to suggest means to bridge this knowledge gap.

The introduction of section 8E of the Act widened the tax net by deeming what would otherwise be a non-taxable dividend to being income, i.e. taxable income. The previously existing tax avoidance loophole was closed.

3.4. SECTION 8EA DIVIDENDS ON THIRD-PARTY BACKED SHARES DEEMED TO BE INCOME IN RELATION TO RECIPIENTS THEREOF

The purpose of this section follows on from 3.3 and deals with the same dividends as in the previous section but is dedicated specifically to those dividends from instruments that are backed by third parties.

During the same time as the review of the Act's section 8E, the introduction of section 8EA also took place. Section 8EA transforms dividends on so-called third-party backed shares as income in specific cases. Third-party backed shares include preference shares that receive an advantage from an executable right that is enforceable against another party, or when that other party has an executable obligation in relation to that share.

Section 8EA of the Act is essentially the same as section 8E but is more specific. It is targeted at third-party backed shares. Simplistically a third-party backed share is backed by a person other than the issuer. The holder has the right to require some person other than the company to acquire the shares. The purpose of section 8EA of the Act is the same as that of section 8E in that they both aim to stop the tax benefit received by using share schemes which are in substance financing or debt arrangements (Callaway, 2014)

Section 8EA of the Act covers situations where the preference shareholders go into other agreements connected to the performance of the preference shares with third parties in order to alleviate the risk intrinsic in the issuing company. Section 8EA (and the security provision described in section 8E) of the Act does not apply where the proceeds of the preference shares are utilised for a so-called 'qualifying purpose' and the enforcement right or enforcement obligation is enforceable against a stated list of persons. A 'qualifying purpose' refers to the proceeds of the preference shares being utilised for the direct or indirect purchase of equity shares. The 'qualifying purpose' also permits for the proceeds to be utilised for the refinancing of debt (and any associated interest thereon) or preference shares (and any associated dividends thereon) where the proceeds of the original funding were used to directly or indirectly to procure equity shares (Tettey, 2016).

The key elements to be on the lookout for in relation to section 8EA of the Act are:

1. Source of payments;
2. Rights to enforce payments;
3. Status in relation to regular corporate creditors; and
4. Use to which advances were put; and risk involved in making advances.

It is common for the providers of debt to necessitate guarantees from other companies within a group of companies to attain access to the assets and cash flows of the significant operating companies in a group of companies. Section 8EA of the Act seems to target this debt-like feature (Tettey, 2016).

In concluding the discourse in relation to section 8E and 8EA of the Act, it becomes clear that they are specifically aimed at particular equity instruments with composite debt-like features. When applicable, the dividend income is re-characterised and transformed into normal income in respect of the holder, thus resulting in such sum being taxed in its entirety. Remarkably, it is worth noting that the section makes no provision for a deduction for the issuing company should dividends be re-characterised as income. Additionally, sections 8E and 8EA of the Act do not serve to re-characterise dividends as interest but rather serve to re-characterise them as income. Thus dividends applicable to sections 8E and 8EA of the Act are therefore not affected by sections of the Act that explicitly apply to interest or dividends as the re-characterised income is neither interest nor dividends (Tettey, 2016).

Once again we have a widening of the tax net by SARS to include structures and instruments that previously escaped taxation. The importance of the amendments in both sections 8E and 8EA of the Act is that the amendments now refer to *'any'* share. There is no limitation or restriction. Spamer (2012) argues that these sections do not by any means simplify tax but serve to require *'a serious devotion of time, let alone the interpretation of the proposed legislation'*.

Hoosen (2014), a Senior Tax Consultant in his article '*Loans disguised under schemes are no more – it is time to restructure'* in the E-Taxline Journal warns that:

> *There is no doubt that sections 8E and 8EA are laden with complexities and taxpayers are urged to seek professional advice to arrange their tax affairs most beneficially and to satisfy themselves of compliance with the Act's provisions.*

3.5. SECTION 8F INTEREST ON HYBRID DEBT INSTRUMENTS DEEMED TO BE DIVIDENDS *IN SPECIE*

Like section 8E of the Act, the first section 8F promulgated in 2004 was also thought to be very limited in its scope and rules. Considerable amendments were thus proposed to section 8F of the Act by National Treasury in 2012. Draft proposals that were released by National Treasury in 2012 were subsequently deleted from the final Taxation Laws Amendment Bill, 2012 because they were found to be excessively wide and pointlessly difficult, thus potentially harming commercial transactions not driven by tax. The proposals were considered again in 2013 and a new draft cognisant of the proposals in 2012 was submitted for promulgation in 2013. It had to be amended and widened accordingly by National Treasury (Essop, 2016). According to National Treasury (2004), the purpose of the amendment was to restrict the deductibility of interest by persons other than natural persons in relation to hybrid debt instruments classified as debt in the legal form but possessing adequate equity element. This clearly placed the financial instrument at the equity tip of the debt/equity paradigm. The restriction's intention was to thwart tax avoidance by ensuring that equity is not masquerading as debt. Section 8F of the Act addresses the envisaged avoidance and disallows the deduction of the interest charge or interest payable in respect of the financial instruments (Essop, 2016).

Essop (2016) further argues that it simultaneously, almost by a sleight of hand, manages to treat sums due in respect of the instrument as taxable interest from the holder's point of view. With regards to a company, the interest charge of the instruments under examination is considered a dividend declared. The conventional dividend tax rules would then be of relevance and applicability. A detailed discussion on dividends, suffice to say, does not constitute a part of the scope of this paper.

This paragraph looks at one aspect, namely the three year period its impact and resulting tax treatment as an example. There is an attempt by the revenue authorities to limit the tax deductibility of the interest on hybrid debt instruments. The three year period, as in section 8E of the Act, will be from either the date on which the instrument is issued or from the date on which that instrument becomes convertible into or exchangeable for a share if these rights are formed following the actual date of issue. The restriction of the deduction is encompassed in section 8F(2) of the Act and serves to restrict the quantum of deductible interest permissible for hybrid debt instruments.

The section's attention is primarily on companies and any person where a connected person that is a company is to issue shares. It has broad application and applies to any issuer of convertible or exchangeable debt for a share in the issuer or a share of a connected person in regards to the issuer. This would encompass the eventuality where a party contracts as a party to a loan agreement which requires repayment within three years in the form of shares in the party's wholly owned company. In accordance with this section, interest payments made in with regards to affected instruments by an issuer are not deductible in relation to certain instruments (National Treasury, 2004).

In summary, section 8F of the Act is an anti-avoidance provision that ensured that from 1 April 2014 interest incurred on interest-bearing subordinated debt ceased to be deductible (Grant Thornton, 2015). The view of the revenue authorities is that given that a subordinated loan is suspended until the fulfilment of a certain condition, the lender does not have an unconditional right to the loan. The interpretation in its most simple form is that there is no loan until the condition is fulfilled and therefore there should be no interest deduction granted. The legal consequence of a loan subordination is that repayments can only begin once the assets of the debtor, fairly valued, exceed its liabilities, also fairly valued, which places subordinated debt directly within the limitations of par (*b*) of the definition of a 'hybrid debt instrument' (Grant Thornton, 2015).

There have been further amendments to Section 8F of the Act, with the latest one being with effect from 24 February 2016. The latest amendment is applicable in respect of amounts incurred in respect of an instrument on or after 24 February 2016. Relief has been provided in that, with effect from 1 January 2016, a subordinated hybrid debt instrument will fall out of the hybrid debt rules if certain criteria are met (ENSafrica, 2017). The details have not been delved into but suffice to make the point that the tax treatment of HFIs remains a continuing struggle receiving constant attention.

3.6. SECTION 8FA HYBRID INTEREST DEEMED TO BE DIVIDENDS *IN SPECIE*

Section 8FA of the Act's sole purpose is to address the company's returns such as interest and yields on financial instruments. The application of section 8FA of the Act is not limited to hybrid debt instruments but stretches to include any instrument. The section empowers the revenue authorities to re-characterise interest by deeming it a dividend. A cautionary note has to be made at this juncture. Section 8FA of the Act does not re-characterise the instrument; it is only the character of the yield that is altered (Tettey, 2016).

Sections 8F and 8FA of the Act are anti-avoidance rules zeroing in on debt instruments with features akin to equity. They consider interest income as dividends *in specie* where pertinent and are taxed accordingly. The deduction of the interest is not permitted for the issuing company and the debt holder receives an exempt return (Tettey, 2016).

Section 8FA, like section 8F of the Act, forms part of the anti-avoidance rules and effectively reclassifies debt instruments as equity if the provisions of the instrument or the source for the calculation of the yield comprises specific equity-like features. If these regulations are applicable, the interest is reclassified as a dividend *in specie* and the issuer is deprived of the interest deduction (EY Global Tax Alert, 2016).

This section has covered an overview of sections 8E, 8EA, 8F and 8EA of the Act, as well as having chronologically mapped out South Africa's attempts at addressing the tax treatment of HFIs in relation to dividends, interest and dividends *in specie*.

3.7. CONCLUSION

The duty of the SA National Treasury is to ensure that the SA tax base is not eroded. The combatting of tax avoidance and protection of the tax base remains at the helm. There have been concerted endeavours to deal with unwarranted interest deductions by essentially reversing them. The specific nature of the sections and the definitions covered in sections 8E, 8EA, 8F and 8FA of the Act attempt to mitigate the risk of the legislation being open to wide and subjective interpretation.

The purpose here is to strive for clarity, precision, and the removal of doubt. The disadvantage is that where definitions are very specific in nature, there is the risk of instruments that are intended to be caught by the precise definition being inadvertently excluded.

In summary, Wortmann (2015) argues that the framework of the Act aggravates the necessity for debt-like equity instruments to address the non-deducibility of interest by issuing debt to fund the purchase of equity. The numerous security positions, exclusions and interpretation required for the sections 8E and 8EA make for a complex form of taxation (Wortmann, 2015).

Having concluded the discussion on the SA tax law treatment of HFIs the present study prepares to go beyond the borders of SA and commences as review of the international tax treatment of HFIs.

CHAPTER 4. INTERNATIONAL TAX TREATMENT OF HYBRID FINANCIAL INSTRUMENTS

4.1. INTRODUCTION

The purpose of this chapter is to review the international tax treatment of HFIs, discuss the role of DTAs in relation to domestic law and lastly to investigate which law takes precedence in the context of DTAs. While HFIs may merge features of debt and equity in any numerous ways, tax classifications commonly categorise all such instruments as debt or as equity. The leading complications arise from the inherent complication of such instruments, having an instrument deemed debt in country A where a payment on the instrument is tax deductible, while in country, B the instrument is viewed as equity and the proceeds represent a tax-exempt dividend.

As tax conventions differ amongst countries, there is substantial disparity in the regulations that determine debt and equity. Thus the discrepancy between equity and debt for tax reasons is of significant relevance in many jurisdictions (Niels & Van Gelder, 2013). Johannesen (2014) postulates that a lack of clarity in the determination and categorisation of HFIs is on account of the inaccessibility of information in a timeous manner in order to permit authorities to establish an enhanced response time. The density and depth of the difficulties on this subject matter are derived from a variety of rationales such as multiplicity and flexible utilisation of the instruments, diverse legal, accounting and regulatory frameworks, as well as cross-border repercussions (Johannesen, 2014).

Global and cross-border dissimilarities in demarcation regulations present the prospect that the same financial instrument is categorised as debt in one country and equity in another country. A practical illustration of this ‘double non-taxation’ can be found in structures where US investments in Europe have utilised the Luxembourg hub as a conduit by the US companies holding private equity certificates of the Luxembourg company.

These are instruments regarded by the US as capital thus generating ‘tax-free’ dividends, while Luxembourg regards them as debt, incurring deductible interest (Decamp, 2016).

The next section will examine the current argument within the EU, the OECD, and the Group of Twenty (G20) on tax avoidance over-all and the usage of mismatches by hybrid finance instruments.

4.2. INTERNATIONAL TRENDS

4.2.1 ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a distinctive medium where authorities and leaderships collaborate to confront the economic, social, and environmental difficulties of globalisation. The organisation offers a backdrop where governments can contrast policy familiarities, look for replies to mutual complications, recognise good practice, and strive to co-ordinate domestic and international policies.

The OECD members are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the UK and the US (The OECD, 2008).

Although South Africa is not a member of the OECD, in 2007 the OECD Council at Ministerial level implemented a resolution which led to South Africa’s becoming one of five vital partners to the OECD, along with Brazil, China, India and Indonesia. Key partners add to the OECD’s efforts in a continuous and all-inclusive method. As the OECD and South Africa entrench their co-operation and relations, SA policy makers obtain entry to OECD expertise and good policy procedures (OECD, 2018).

A recent report by the OECD on Hybrid Mismatch Arrangements indicates the purpose and aim of the OECD in curbing the exploitation of variations in the treatment of the tax attributable to an entity or instrument under the laws of two or more countries to accomplish double non-taxation, including enduring deferral (OECD, 2015).

In some States, preference shares assume a hybrid *persona* because dividend disbursements are regarded as a tax-deductible cost of finance. The receiving State grants a participation exemption to the preferred dividend. Germany has domestic regulations that do not permit a dividend exemption when the payer received a deduction in the country of residence. Additional countries disallowing this particular exemption include Austria, Italy, New Zealand, South Africa, and the UK. Several examples of where profit participating interest, or interest on hybrid convertible debt, could be refused follow.

The refusal or disallowance of a dividend is accomplished by treating the payment as a dividend, as is the case in Australia and the UK. The second example in relation to the US in that, when a US foreign holding hybrid entity incurs interest by utilising the US's check-the-box rules[1] tax beneficial tax consolidation may be denied in the host country. Denmark and the UK apply these anti-hybrid rules. Lastly, subject-to-tax conditions that diminish interest paid on HFIs from reduced withholding taxes may be brought to bear by some treaties. These are typically found in most German treaties (Davis Tax Committee, 2015).

Paramount to understanding the implications and treatments of HFIs is knowing the difference between debt and equity. The consequential treatment of a hybrid debt instrument is not the same as that of hybrid equity instrument. An appreciation of the peculiarity of each instrument is therefore well advised. In Schön *et al.'s* (2009) paper

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[1] The check-the-box rules (Reg. section 301.7701-3) permit a US-based multinational company with subsidiary companies in other tax jurisdictions to steer income through its subsidiaries without the US CFC rules (subpart F rules) and other countries' CFC rules applying. This is because all the transactions are disregarded.

on *Debt and Equity: What's the Difference*[2], in discerning the distinction, the key issue seems to turn on whether the instrument confers a right to participate in profits. Schön *et al.* (2009) argue that this plays, *'prima facie a substantive role for the characterisation'*. The OECD includes, as dividends, income from participation certificates. However, income from profit participating loans falls outside the ambit of the concept of dividends as articulated in the OECD model convention. The article on interest of the OECD model convention, on the other hand, looks at all manner of debt and is broad (OECD, 2014).

Even the universally established language *'whether or not carrying a right to participate in the debtor's profits'* used in Model Income Treaties to describe interest does not alter the formal stance since this caution and exception does not narrow what is termed 'interest'. A participation in profits is not a characteristic of a debt claim and does not alter the debt element of an instrument. It is not decisive in the decision-making process when concluding whether an instrument is debt or equity.

Interest includes income from profit participating loans and sub-ordinated loans and there is clear reference to income from bonds. There are particular sources of income stemming from options, convertible bonds, and mandatory convertible bonds, and these are treated as interest. The stipulation of the varying forms of mezzanine capital as ownership rights in the wider consideration or debt claims is pivotal; therefore, ultimately, a very formal approach prevails. It is accepted that participation in profits is not of primary concern as a determinant of distinguishing between debt and equity in this respect. What is of fundamental importance is the nomination within the prior article on dividends (Schön *et al.*, 2009).

The section that follows examines on a high level the international legislative provisions attacking double deductions. The following countries, UK, Denmark,

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[2] Due to the number of authors, the citation is limited to Schön *et al*. The citation includes the following authors, Wolfgang Schön and Tobias Beuchert, Astrid Erker, Andreas Gerten, Maximilian Haag, Sabine Heidenbauer, Carsten Hohmann, Daniel Kornack, Nadia Lagdali, Lukas Müller, Christine Osterloh-Konrad, Carlo Pohlhausen, Philipp Redeker and Erik Röder.

Austria, Germany and the EU have regulations administering the deductibility of a payment or expense already deducted in another tax jurisdiction (Davis Tax Committee, 2015).

A brief glance at international tax legislation provisions denying the deduction of payments not matched by the taxation of payments in the payee's jurisdiction is provided below. Annexure 2 of the Davis Tax Committee: Second Interim Report on Base Erosion and Profit Shifting (BEPS) in South Africa was used as the primary source of reviewing the tax treatment of HFIs in the chosen jurisdictions.

4.2.2 UNITED KINGDOM

Section 244 of the Taxation (International and Other Provisions) Act 2010 for the purposes of the UK Corporation Tax Acts disallows for the double deduction of an expense item if it is not matched by a reciprocal UK taxable receipt. This is specifically applicable where an HFI is utilised via a scheme to increase the deduction than would ordinarily be permissible under UK tax law (Taxation (International and Other Provisions) Act of 2010, United Kingdom).

It is worth noting that the limitation is not applicable to a scheme that does not affect UK taxation. On application of the legislation, the UK limits the tax deduction and reverses the out of the ordinary increase in the deduction. The purpose is to discourage unmatched UK tax deductions, i.e. those without a UK taxable income or in some instances expenses already accounted elsewhere (Davis Tax Committee, 2015). This highlights the UK's efforts to close any tax leakage by ensuring that every tax deduction granted in the UK is matched by a UK receipt. Without this application the UK would suffer an erosion of its tax base in view of the excessive and out of the ordinary tax deductions obtained by using HFIs.

4.2.3 DENMARK

Section 2B of the Danish Corporate Income Tax Act of 1969, is aimed at addressing specifically, tax arbitrage structures utilising HFIs (Corporate Income Tax, Act of 1969, Netherlands). This specific anti-arbitrage provision is considered under the following circumstance. On fulfilment of several specified requirements, the tax arbitrage HFI is reclassified as equity for Danish tax computation means. The resultant output is that any interest paid and capital losses incurred end up being regarded as dividend payments effected by the Danish debtor company. No deduction is forthcoming. In addition, the withholding tax rate that is applied to the newly classified dividend differs from the rate applicable to interest and capital gains (Davis Tax Committee, 2015). The latter treatment mirrors South Africa's tax treatment in section 8F of the Act in all material respects. The three substantive similarities are firstly, the reclassification of the instrument as equity, secondly, deeming interest paid a dividend and the withholding of tax on the dividend as a requirement.

The receipt of dividends by a Danish parent company does result in tax exemption if the subsidiary making the payment is allowed a tax deduction in relation to the dividend paid to the Danish parent company (Davis Tax Committee, 2015). Given that this is a Danish-to-Danish transaction and not a cross-border transaction Denmark is not prejudiced by granting the tax exemption on the receipt of dividends.

4.2.4 AUSTRIA

Austria has also attempted to address the tax leakage that arises from the use of HFIs. Austria offers a conditional tax exemption. As far as the Austrian tax law is concerned, income stemming from HFIs comprising investments in equity will only receive a tax exemption under the Austrian participation exemption framework where the payer's expense is not entitled to a tax deduction (Davis Tax Committee, 2015). This is similar to South Africa's equitable tax treatment of dividends which are philosophically speaking paid from after tax profits have theoretically already been taxed and when paid to the shareholder are exempt so as avoid the inequitable pitfalls of double taxation of the same proceeds.

4.2.5 GERMANY

The genesis of the Parent–Subsidiary Directive (Directive) stems from a desire remove tax hindrances for the distribution of earnings between parent companies and subsidiaries established in different Member States. The Directive therefore grants a tax exemption in respect of dividends and other profit distributions made by subsidiary companies to their parent companies. This eradicates the possibility of double taxation i.e. the same income being taxed in the Member State of the subsidiary and Member State of the parent company (European Commission, 2013). The avoidance of double taxation is demonstrated by the Directive. The concept and avoidance of double taxation is of such critical importance that it forms the cornerstone of all if not most DTAs. The dividend in the hands of the recipient shareholder is ordinarily exempt from tax. The Directive reduces the domestic dividend withholding tax to nil if the dividends are paid to a qualifying EU shareholder that owns at least 10% of the subsidiary (Davis Tax Committee, 2015).

4.2.6 EUROPEAN UNION

Austria, Denmark, Germany and the UK have promulgated laws which disallow exempt income that is a tax deduction in another tax jurisdiction. This view has been supported by the EU Code of Conduct Group (Business Taxation) as the correct method of combatting arbitrage with HFIs. A further development by the Group has been the proposal regarding payments relating to hybrid loan arrangements. The tax deductible payment for the debtor/payer should be denied by the EU Member States and treated as profit distributions/dividends under the participation exemption (Davis Tax Committee, 2015).

The normally tax-deductible interest payment is being denied and is being treated as a dividend. The EU and South Africa have both promulgated essentially the same laws to target the abuse of HFI as a tax avoidance mechanism.

Figure 2-3: States that do not allow a dividend exemption (Researcher's own work, 2019)

The above figure supports the postulation that there is convergence in the selected jurisdictions as to how they treat HFIs.

In conclusion, despite the limited sample of countries above research and reading indicate the prevalence of the use of HFIs as tax avoidance instruments to be a worldwide phenomenon that is not only unique to South Africa. The efforts and purposes of South Africa's legislation is analogous to those of other countries showing a global convergence in the stratagems to deal with HFIs. The harmonisation trend shown above leads to worldwide tax-efficiency. No one country carries the burden of granting deductions and on the contrary no single country has the benefit of being the recipient of taxable incomes (Menuchin, 2005).

The inconsistencies in the tax legislation of the various tax jurisdictions lead to certain queer anomalies such as a taxpayer being taxed twice, once in the resident country and again in the country where the income is sourced. There is the double deduction irony where a taxpayer may receive a deduction in his country of residence and another deduction in the country where the deduction is sourced. Clearly, it is not the intention of tax authorities that taxpayers receive double deductions thus "double dipping". DTAs serve to assist with the harmonisation (referred to in the previous paragraph) of tax practices. A review of DTAs thus follows.

4.3. DOUBLE TAX AGREEMENTS

Countries enter into tax treaties to prevent double taxation. DTAs are international treaties that are agreed and signed between governments principally to inhibit double taxation on cross-border income. The tax occurrence for taxpayers using international transactions can be decreased where there is a DTA between the taxpayer's country of residence and the country from which the income is sourced (Peters, 2016).

DTAs serve to address both double taxation and double non-taxation as both instances are equally problematic. The logic is premised on the fact that the double non-taxation of profits twists competition as it gives an 'unwarranted' competitive advantage to multi-national corporations at the expense of the domestic company subject to ordinary (local) taxation.

The most prevalent usage to take advantage of double non-taxation is found when firms use HFIs. The following example illustrates the point. Take for instance, if an HFI is categorised as debt in country B and as equity in country A, a double non-taxation of profits opportunity develops and now becomes possible. Assume the subsidiary in country B funds its investment by means of the hybrid instrument. Then, the subsidiary benefits from interest deductions that take away the corporate tax burden in country B. In addition, the yield on the HFI received in the parent country of the Multi-National Enterprise (MNE) is observed and treated as if it were a return to equity, i.e. dividends (instead of interest income), and is thus tax exempt in the event that country A has a territorial tax system in place (Edgar & Stimmelmayr, 2017).

International double taxation may be removed bilaterally utilising treaties or unilaterally via domestic law in numerous methods:

- Bilaterally – by allocating the exclusive taxing right to one country, thus permitting only one country to tax the particular item of income and subsequently eliminating double taxation.
- Bilaterally and unilaterally – based on the special method for the elimination of double taxation by the credit relief method; for example the section 6quat rebate for foreign taxes paid on income which is available to SA residents whose income has been the subject of taxation in the other countries or the exemption method using MAP.

  Source: (United Nations, 2011).

As demonstrated above, the credit and exemption methods may be used in unilateral or bilateral tax treaties. In order to apply the above DTA principles from a SA perspective an analysis of the status of DTAs in SA law may be required. What is South Africa's position in relation to DTAs? This is further examined by asking this question, 'Are DTAs self-executing or not?' Self-executing; meaning that DTAs apply automatically and automatically overrides local SA tax law. If the answer is in the affirmative, then DTAs become law once parliament has approved them. Based on the latter, section 108(2) of the Act titled "*Prevention of or relief from, double taxation"* does not become the enacting legislation. Section 108(2) reads:

> *'As soon as may be after the approval by Parliament any such agreement, as contemplated in section 231 of the Constitution, the arrangements thereby made shall be notified by publication in the Gazette and the arrangements so notified shall thereupon have effect as if enacted in this Act.'*

The opposing view is that DTAs are not self-executing and become law by national legislation. This would suggest that domestic law, and not the treaty, should be the point of departure. This is clearly supported by case law as the court in *Krok v The Commissioner for the South African Revenue Service* *(SCA) Unreported Case Numbers 20230/2014 and 20232/2014 of 15 August 2015* considered publication in the Government Gazette as a *sine qua non* for the DTA to become 'part of SA law'. Had the agreement been self-executing, publication in the Government Gazette would not have been a requirement and it (the DTA) would simply be law on approval by parliament (Du Plessis, 2015).

South Africa has recognised the dilemma of double taxation. It has, as part of its armoury, elements such as Section 6*quat* of the Act in relation to '*Rebate or deduction in respect of foreign taxes on income'*. Sections 6*quat* and 108(2) collectively seek to alleviate the burden to the taxpayer. There is a recognition and positive appreciation of taxes already paid in foreign tax jurisdictions. The contentious view is where there is a DTA and local law; which of the two prevails? One view is that treaties hold the same position or level as the Constitution and therefore hold the highest position. They are therefore higher than domestic law (Du Plessis, 2015).

Glenister puts forward a contradictory point,

> *'It follows that the incorporation of an international agreement creates ordinary domestic statutory obligations. Incorporation by itself does not transform the rights and obligations in it into constitutional rights and obligations' (Glenister v President of the RSA 2011 (3) SA 347 (CC) para 181).*

In *AM Moola Group Ltd v CSARS 65 SATC 414*, 2003, the court was of the view that in the event of a conflict between local law and treaty provisions, local law must prevail. In *Commissioner for the South African Revenue Service v Tradehold Ltd (132/11) [2012] ZASCA 61 (8 MAY 2012)*, it was felt that the treaty should override.

In *Commissioner for the South African Revenue Service v Van Kets 2012 3 SA 399 (WCC),* it was suggested that the Double Tax Treaty (DTT) at a minimum ranks the same as local law. Some publicly expressed views argue, although not with certainty, that DTAs override domestic law because of domestic interpretation rules. Treaty override is unlikely and would most likely occur where there is no other intermediary type of interpretation (Du Plessis, 2015).

The selected cases above demonstrate the lack of certainty. *AM Moola* felt local prevailed. *Tradehold* was of the view that the treaty should override. The balancing case was *Van Kets* which felt that local law and DTTs rank equally. There is thus no definitive view.

4.4. CONCLUSION

Admittedly, the modifications in the tax legislation alluded to above are applicable in narrow and very specific instances. The endeavours to curb the tax benefits from hybrid mismatches is, however, noticeable in numerous countries and is being dealt with.

In relation to this study, in Chapter 3: South African Tax Law Treatment of Hybrid Financial Instruments, it is self-evident that South Africa has developed provisions for the tax treatment of HFIs. What is of significance and should perhaps be of concern is the deficiency of domestic and international matching in the deduction, and subsequent taxation, of the same set of funds in between two jurisdictions (Davis Tax Committee, 2015). South Africa is well poised and positioned to neutralise the effects of HFIs by implement the outcomes of the document formally known as the *Davis Tax Committee: Second interim Report on Base Erosion and Profit shifting (BEPS) in South Africa's Summary Report on Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements* (Kuzniacki *et al.*, 2017)[3]. Kuźniacki *et al.*, (2017) go on to compliment South Africa as a country that is prepared, legally and structurally, to develop an environment and best practices to combat tax avoidance.

The third sub-objective in relation to the matter of which law takes precedence where there is a conflict between selected jurisdictions remains unresolved. Our own SA law has on occasion delivered contradictory judgments, as is demonstrated in the *AM Moola* and *Tradehold* cases (Du Plessis, 2015). Germany, Switzerland and the US are examples of international countries that have explicit domestic override legislation that denies treaty reductions. It stops the treaty reduction from imposing full withholding taxes on outward going hybrid interest (Davis Tax Committee, 2015).

Similar to domestic anti-avoidance matters, caution and care has to be taken to separate abusive arrangements and those that are in accordance with the purposes of the tax treaty in question (Baker, 2013). Notwithstanding the latter, the conflict between treaties and domestic legislation has not been solved entirely (Oguttu, 2015).

The research is inconclusive in terms which law takes precedence when a determination has to be made between domestic law and a DTA. Case law in respect of which law between domestic law and DTAs ranks superior will have to develop over time. Given the complexities of such matters and the fact that the revenue authorities

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3 Due to the number of authors, the citation is limited to Kuźniacki *et al.* The citation includes the following authors, Alessandro Turina, Thomas Dubut, Addy Mazz, Natalia Quiñones, Luís Eduardo Schoueri, Craig West, Pasquale Pistone and Frederik Zimmer.

opt for this challenging avenue as a last resort, only serves to set the scene for the continuance of the inconclusiveness in asserting whether DTAs override domestic law.

CHAPTER 5. CONCLUSION

At the outset in Section 1.3 the research report covered the research objectives and purpose of the present study. To re-iterate, the overarching objective was to afford an inclusive synopsis of the uneven tax treatment of HFIs in the international arena with a particular emphasis on SA tax legislation and a comparative appraisal of South Africa and the selected sample of tax jurisdictions. In order to respond to the latter overall objective, four sub-objectives were deemed apt and addressed accordingly. Drawing to a conclusion, what now follows is firstly, a broad outline of the achievement of the objective and sub-objectives secondly, an explanation as to how the sub-objectives were addressed and finally what the findings and conclusion were. The closing remark is a reflection on the overall objective.

The first sub-objective found in Section 1.3 is to define HFIs from a SA perspective and to describe the SA tax law treatment of HFIs. Two questions were asked to address this objective, namely: 1) What is a HFI and what constitutes a hybrid mismatch arrangement?; and 2) What is the SA tax law treatment of HFIs? It (the first sub-objective) was obtained by introducing the concept of HFIs and hybrid mismatch arrangements in international finance and their significance in the resulting tax treatment by various countries when juxtaposed with the cross-border context.

These are the findings and conclusion gleaned from the achievement of the first sub-objective. The complexity, in Chapter 2 where HFIs and Hybrid Mismatch Arrangements were explained, was found to be not in the identification of a HFI but rather in determining the applicable tax treatment in as far as it relates to the debt and equity features around deductible and taxable interest and exempt dividend income and payments, for example.

Chapter 3 focussed on the SA tax law treatment of HFIs in accordance with the second part of the first sub-objective being to describe the SA tax law treatment of HFIs. The chapter presented the SA framework in relation to HFIs and concluded with a remark that the numerous security positions, exclusions and interpretation required for the sections 8E and 8EA make for a complex form of taxation.

Chapter 4 was dedicated to the remaining three sub-objectives namely:

- To explore and highlight the convergence or lack thereof in the international tax treatment of HFIs;
- To discuss the role of DTA's in relation to domestic law and to investigate which law takes precedence; and
- To establish whether the SA tax treatment is in line with the countries reviewed.

After having a crisp understanding of HFIs from a SA perspective and the subsequent tax treatment in SA an investigation into the second sub-objective, "to explore and highlight the convergence or lack thereof in the international tax treatment of HFIs", followed. The question "what are the HFI tax implications from an international and DTA perspective, with a specific reference to the UK, Denmark, Austria, Germany and the EU and is SA in line with the latter sample of countries?", guided the analysis and interpretation of data as presented in Chapter 4. This sub-objective was accomplished by exploring and highlighting the convergence or lack thereof in the international tax treatment of HFIs. The exploration included a brief study of the OECD as a global organisation reflective of its predominantly first-world member states. The applicability to South Africa lies in the fact that although South Africa is does not hold membership in the OECD, it is one of the five critical associates to the OECD. South Africa therefore has indirect input into OECD policies and procedures *vice versa*.

The findings and conclusion pertaining to the second sub-objective confirm the global convergence and willingness to strive towards the harmonisation of the international tax treatment of HFIs. This would translate into no single country having the unappealing burden of granting deductions without receiving the equal but opposite benefit when income which should be included is somehow by 'slight of hand' deemed exempt income.

The third sub-objective, "to discuss the role of DTA's in relation to domestic law and to investigate which law takes precedence", was realised by an in-depth discussion of the role of DTAs in relation to domestic law and an investigation into which law takes precedence. DTAs provide certainty and much sought after assurances into the predictability of the tax outcome of cross-border transactions. The purpose is to avoid double non-taxation as well as double taxation.

The findings and conclusion applicable to the third sub-objective are that the in-depth discussion resulted in the following finding. A recollection of the conflict and incongruity in the application of the tax laws between domestic and foreign tax laws demonstrates the inadequacy of the provisions in the absence of global consensus. The three cases of *Moola, Tradehold* and *Van Kets* that were examined yielded three different results. *Moola* was of the considered view that domestic legislation ranks supreme to the DTA, *Tradehold* held that the DTA should override SA law and *Van Kets* ranked the DTA and SA law on an equal footing at a minimum.

The fourth sub-objective, “to establish whether the SA tax treatment is in line with the countries reviewed”, was completed by a methodical examination of the universal tax conduct of HFIs. The discussion looked at the disparity in the legislations that determine debt and equity.

The findings and conclusion garnered from the fourth sub-objective are: borrowing from the international experience, it becomes apparent that the HFI regime is vulnerable to subjective juristic interpretations. Notwithstanding the latter representation, reference is made to Section 4.2 sub-titled *International Trends* of this research paper. There is convergence in the tax administration of the deductibility of a payment or expense already deducted as demonstrated by the South African, English, Danish, Austrian, German and EU examples already cited. In support of this observation is the acknowledgment of South Africa’s application of Section 6quat of the Act where a credit is granted for income that has been the subject of taxation in other countries.

The chronological tax developments discussed earlier demonstrate that South Africa is certainly striving to be in line with the countries reviewed. The South African HFI legislation has progressed in leaps and bounds to such an extent that it has oft been criticised for being too complicated in its eagerness to be in line with international best practice. HFIs are by their nature complex and complicated creatures the opposing legislation will to some extent have to be equally complex and complicated if it is to have a meaningful impact.

The two-pronged purpose of the research is firstly, to bring to the reader's attention policy options and legislation to address the identified hybrid mismatch arrangements. Secondly, to contribute to the understanding of what HFIs are and how the SA tax treatment is similar or dissimilar to that of the few countries cited in the research. The present report has contributed to the comprehension of what HFIs are and the extent to which the SA treatment may or may not contrast the countries cited herein.

Reflection on the overall objective and purpose of the study behoves the acceptance that there is no uniformity in the international tax treatment of HFIs. There are differences but the willingness and appreciation of the economic benefits of uniformity and convergence are well-documented and welcome by most tax authorities and taxpayers alike. SA tax legislation, the OECD and the countries in the sample size have been discussed and reviewed in a concerted effort to bring to the reader's consideration policy options and statute to tackle hybrid mismatch arrangements. Additionally, when SA tax law and DTAs contradict each other there is no lucidity in the use and decision-making insofar as which law is to take primacy. This is aggravated by the worldwide, multi-jurisdictional subjectivity in the treatment of HFIs.

The writer's objective has been to address this by specifically answering the following three recollected research questions:

1. What is a HFI and what constitutes a hybrid mismatch arrangement?
2. What is the SA tax law treatment of HFIs?
3. What are the HFI tax implications from an international and DTA perspective, with a specific reference to the UK, Denmark, Austria, Germany and the EU in order to assess whether SA is in line with the latter sample of countries?

The researcher wishes to conclude that the research confirms the imperative for the continuation of the search for an effective cure in relation to a definitive and globally accepted good practice for the treatment of HFIs.

CHAPTER 6. RECOMMENDATIONS

Research into the plausibility of aligning the provisions of the Act with the OECD to ensure global harmonisation is encouraged. Further research into the identification of mismatches and not an emphasis on the type of instrument in question should be supported. The principle of the research should be on the identification of mismatches as a principle and not so much on the actual instrument itself.

The present study's recommendations add to the body of knowledge in relation to the tax considerations of Hybrid Financial Instruments. The findings made illustrate the need for the continued requirement to find conclusive and internationally acknowledged best practice. The universal synchronisation and an endorsement of further research into the identification of mismatches as a principle and not so much on the substance of the instrument itself is recommended. Tax jurisdictions are not equally sophisticated and the relative infancy of HFIs in the global economy is such that they (HFIs) may not even feature at all in some less sophisticated economies.

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